

DEPARTMENT OF STATE REVENUE

Revenue Ruling #IT 98-02

December 16, 1998

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ISSUE

Gross Income Tax, Adjusted Gross Income Tax, Supplemental Net Income Tax and Sales/Use Tax — Inventory Securitization

Authority: Treas. Reg. Section 301.7701-3(b)(1)(ii), IRC Section 63, IC 6-3-1-3.5, IC 6-3-1-11, IC 6-3-8-2, IC 6-2.1-1-16, IC 6-2.1-1-10, Rule 45 IAC 1-1-58, IRC Section 118; IC 6-2.1-3-3, Rule 45 IAC 1-1-54, IC 6-2.1-1-2, IC 6-2.5-5-6, IC 6-2.5-4-5, IC 6-3-2-2, IC 6-2.5-5-5.1

The taxpayer requests the Department to rule on the application of gross income tax, adjusted gross income tax, supplemental net income tax and sales/use tax to inventory securitization.

STATEMENT OF FACTS

Corporation A owns and operates a production facility in Indiana and, through wholly owned subsidiaries, owns partnership interests in other production facilities in Indiana. Corporation A currently purchases raw materials, processes those materials into finished products, and sells the finished products to its customers. Corporation A generally holds title to the raw materials, work in process and finished goods inventory during all stages of the process.

Corporation A has inventories of tangible personal property including, but not limited to, raw materials, consumables, supplies, work in process and finished goods located throughout Indiana and elsewhere ("Inventory"). Much of this Inventory is purchased by Corporation A exempt from sales and use tax pursuant to the various manufacturing exemptions set forth at IC 6-2.5-5 et seq.

Corporation A is now planning to implement a financing arrangement known as inventory securitization, i.e., borrowing money using substantially all of the Inventory as

security or collateral. This financing arrangement will enable Corporation A to lower its overall borrowing costs.

Most of the accounts receivable from Corporation A's sale of product are sold to an affiliate, Corporation B, that was created to facilitate accounts receivable - based, secured financing. Corporation B is qualified to do business in Indiana. Corporation B files Financial Institutions Tax returns and pays FIT to the State of Indiana. Corporation B and Corporation A file a consolidated gross income tax return pursuant to a prior Departmental ruling.

As contemplated, Corporation A will create a new special purpose, single-member limited liability company, hereinafter "LLC". Corporation A will be the LLC's sole member and sole owner. The LLC will not make an election under Treas. Reg. Section 301.7701 to be treated as a corporation. Therefore, for federal tax purposes, the LLC will be disregarded as an entity separate from its owner, Corporation A. See Treas. Reg. Section 301.7701-3(b)(1)(ii).

For bankruptcy law purposes, the LLC will be "bankruptcy remote" from Corporation A. The constituent documents will, for example, provide that the vote of a person independent from Corporation A (i.e., a person unaffiliated with Corporation A) will be required before the LLC can voluntarily file bankruptcy, and will contain other requirements that the LLC maintain a separate existence, so that a bankruptcy filing by Corporation A would not result in the LLC being consolidated into such Corporation A estate.

The LLC will also hold itself out to the public under its own name as a separate and distinct legal entity. It will conduct its business from an office that is separate and distinct from Corporation A, although such office may be leased from Corporation A or a Corporation A affiliate. The LLC shall have its own books and records and bank accounts. Its assets and liabilities shall also be accounted for separately from those of any other entity or person.

Shortly after the formation of the LLC, Corporation A will sell to the LLC and the LLC will purchase from Corporation A substantially all of Corporation A's Inventory. Thereafter, Corporation A will continue to purchase all tangible personal property needed to make the product, but will sell to the LLC on a daily (or otherwise regular) basis substantially all of the Inventory that it (Corporation A) purchases or otherwise acquires. All such Inventory sold or that will be sold by Corporation A to the LLC is hereinafter referred to as the "Collateral Inventory." Corporation A will continue to own and use certain Inventory and may purchase certain Inventory that is not sold to the LLC, but is instead sold to others.

All of these sales of Collateral Inventory from Corporation A to the LLC will be true sales and title to the Collateral Inventory will pass to the LLC. Pursuant to a Processing and Servicing Agreement, Corporation A will purchase, use, consume, store, maintain, process and sell the Collateral Inventory on behalf of the LLC. The LLC may have few

or no employees and it will own no significant tangible property, other than the Collateral Inventory.

The LLC will pay Corporation A for the Collateral Inventory with Senior Notes secured by the LLC's Collateral Inventory holdings, subordinated notes, by an increase of the equity interest and, if available, cash. The Senior Notes will be secured by, among other things, a pledge of the Collateral Inventory owned by the LLC to an indenture trustee ("Collateral Agent") appointed for that purpose.

Corporation A will then be in a position to and may:

- (i) sell the Senior Notes that it receives from the LLC to third-party financial institutions for cash, and, from time to time, may repurchase such Senior Notes for cash, and/or
- (ii) pledge the Senior Notes that it receives from the LLC to secure Letters of Credit from third-party financial institutions.

Corporation A will not always sell the Senior Notes that it receives from the LLC or pledge them to secure Letters of Credit. Whether the Senior Notes are sold or pledged at any time will depend on Corporation A's cash needs and the availability and attractiveness of alternative funding sources to Corporation A. In short, the creation of the LLC, the conveyance of Collateral Inventory to that entity, and the other facts described in the ruling requests put "in place" the arrangement by which third party lenders are committed to make inventory-secured revolving loans, thus providing a ready source of liquidity for Corporation A.

As noted above, pursuant to a Processing and Servicing Agreement with the LLC, Corporation A will provide the processing and other activities to make and sell finished products. In other words, Corporation A will become a processor. Corporation A will be paid a fee by the LLC for its processing services and other activities on behalf of the LLC. Corporation A will, on behalf of the LLC, sell the finished products, invoicing the customer and shipping the products all for the account of the LLC. Customer purchase orders will be directed to Corporation A or the LLC, and the invoices and other documents generated by the sale will all be in Corporation A's or the LLC's name. The products will be sold to the same customers or types of customers to whom Corporation A currently sells.

The sale of the products will generate accounts receivable, most of which will be sold to Corporation B. Corporation B will pay for these accounts receivable by issuing subordinated notes ("Receivable Notes") to the LLC. As the accounts receivable held by Corporation B are collected, the cash will be used, among others things, to pay off the Receivable Notes issued by Corporation B.

The cash, in repayment of the Receivable Notes issued by Corporation B to the LLC, will actually be received by Corporation A, acting as servicer for the LLC and on behalf of the Collateral Agent. Corporation A will generally apply that cash as follows: first, cash

will be paid to the Collateral Agent that will use it to pay interest and principal on the Senior Notes held by the third-party lenders; second, cash will be used to pay all of the expenses of the LLC, and/or used to pay the subordinated notes issued by the LLC to Corporation A and/or used by the LLC to purchase new Collateral Inventory from Corporation A; third, cash will be used to repay principal on remaining Senior Notes; and fourth, cash will be distributed to Corporation A, as the sole member of the LLC.

Following the submission of its ruling request, but before implementation of the inventory securitization described herein, Corporation A advised the Department that its parent corporation had sold all of its stock in Corporation A to Corporation C, an unaffiliated third party, and that an IRC Section 338(h)(10) election was made to treat this stock sale as an asset sale by Corporation A for federal income tax purposes. However, after the acquisition of Corporation A's stock by Corporation C, Corporation A will continue to own 100% of the stock of Corporation B.

DISCUSSION AND RULINGS

Corporation A submitted the following statements addressing income tax issues for Departmental review:

1. The LLC will be ignored as an entity separate from Corporation A for gross income tax, adjusted gross income tax and supplemental net income tax purposes and will not itself be subject to or have any liability for gross income tax, adjusted gross income tax, or supplemental net income tax.

RULING

Pursuant to Treas. Reg. Section 301.7701-3(b)(1)(ii), Internal Revenue Code Section 63, IC 6-3-1-3.5, IC 6-3-1-11, IC 6-3-8-2, IC 6-2.1-1-16 and IC 6-2.1-1-10, a single member LLC that is disregarded as an entity for federal income tax purposes is, also, disregarded as an entity separate from its owner for Indiana gross income tax, adjusted gross income tax and supplemental net income tax purposes. The Department rules, therefore, that the LLC will be ignored as an entity separate from Corporation A for gross income tax, adjusted gross income tax and supplemental net income tax purposes and will not itself be subject to or have any liability for gross income tax, adjusted gross income tax or supplemental net income tax.

2. The creation and capitalization of the LLC by Corporation A will not result in any Indiana gross income tax, adjusted gross income tax, or supplemental net income tax liabilities to Corporation A.

RULING

Pursuant to Rule 45 IAC 1-1-58, Internal Revenue Code Section 118, IC 6-3-1-3.5, IC 6-3-1-11 and IC 6-3-8-2, the capitalization of an LLC by a corporation is not a taxable event for gross income tax, adjusted gross income tax and supplemental net income tax purposes. The Department rules, therefore, that the creation and capitalization of the LLC by Corporation A will not result in any gross income tax, adjusted gross income tax or supplemental net income tax liabilities to Corporation A.

3. Corporation A will have no gross income tax liability on amounts that it receives from the LLC, including amounts:
 - (a) received from sales of Collateral Inventory to the LLC;
 - (b) received for the processing of Collateral Inventory into products and for any other activities that Corporation A performs for or on behalf of the LLC; and
 - (c) received as distributions from the LLC.

RULING

IC 6-2.1-1-16 and IC 6-2.1-1-10 provide that a single member LLC that is disregarded as an entity for federal income tax purposes is, also, disregarded as an entity separate from its owner for gross income tax purposes. The Department rules, therefore, that Corporation A will have no gross income tax liability on amounts that it receives from the LLC, including amounts:

- (a) received from sales of Collateral Inventory to the LLC;
 - (b) received for the processing of Collateral Inventory into products and for any other activities that Corporation A performs for or on an behalf of the LLC; and
 - (c) received as distributions from the LLC.
4. Corporation A will have no gross income tax liability on the amounts it receives on behalf of or as servicer to the LLC, or on behalf of the Collateral Agent.

RULING

IC 6-2.1-1-16 and IC 6-2.1-1-10 provide that a single member LLC that is disregarded as an entity for federal income tax purposes is also disregarded as an entity separate from its owner for gross income tax purposes. Such being the case, any amounts received by Corporation A on behalf of, or as servicer for, the LLC from third parties are, in fact, received by Corporation A. The Department rules, therefore, that these amounts received by Corporation A from third parties will be subject to gross income taxation at the applicable rate (e.g., at the low rate on amounts from the LLC's sales of goods) unless exempt, deductible, or otherwise nontaxable pursuant to a specific provision found in IC 6-2.1. However, the Department confirms that to the extent such amounts are taxable, such amounts will be includable in Corporation A's gross income only once, not twice, i.e., such amounts, if taxable, will not be included twice in Corporation A's gross income, once as received by Corporation A and once as received by the LLC.

Rule 45 IAC 1-1-54 states that, "taxpayers are not subject to gross income tax on income received in an agency capacity." The Department rules, therefore, that Corporation A will have no gross income tax liability on the amounts it receives on behalf of the Collateral Agent in an agency capacity.

5. The LLC will be ignored as a separate entity from Corporation A for gross income tax exemption purposes and Corporation A will be entitled to an exemption from Indiana gross income tax on receipts from the LLC's sale of products or other items (which will be treated as receipts of Corporation A under IC 6-2.1-1-10), to the extent such receipts qualify for exemption if they had been received directly by Corporation A from the sale of products or other items. Specifically, to the extent the sale of products or other items by the LLC would, ignoring the LLC as an entity separate from Corporation A, be exempt from gross income tax as a nontaxable outshipment under IC 6-2.1-3-3 or the regulations promulgated by the Department, Corporation A will be afforded the same exemption(s) in reporting those receipts for gross income tax purposes.

RULING

IC 6-2.1-3-3 provides that, "Gross income derived from business conducted in commerce between the State of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the State of Indiana is prohibited from taxing that gross income by the United States Constitution." The Department rules, therefore, that the LLC will be ignored as a separate entity from Corporation A for gross income tax exemption purposes and Corporation A will be entitled to an exemption from Indiana gross income tax on receipts from the LLC's sale of products or other items (which will be treated as receipts of Corporation A under IC 6-2.1-1-10), to the extent such receipts qualify for exemption if they had been received directly by Corporation A from the sale of products or other items. Specifically, to the extent the sale of products or other items by the LLC would, ignoring the LLC as an entity separate from Corporation A, be exempt from gross income tax as a nontaxable outshipment under IC 6-2.1-3-3 or the regulations promulgated by the Department, Corporation A will be afforded the same exemption(s) in reporting those receipts for gross income tax purposes.

6. Corporation A may continue to file consolidated gross income tax returns with Corporation B and will be entitled to deduct on those consolidated returns the LLC's receipts from the sale of accounts receivable to Corporation B, just as it is currently deducting the receipts from its sale of accounts receivable to Corporation B.

RULING

Consistent with a prior Departmental ruling, the Department rules that Corporation A may continue to file consolidated gross income tax returns with Corporation B and will be entitled to deduct on those consolidated returns the receipts from the LLC's sale of accounts receivable to Corporation B (which will be treated as receipts of Corporation A under IC 6-2.1-1-10), just as it is currently deducting the receipts from its sale of accounts receivable to Corporation B.

7. Corporation A will have no gross income tax liability on the sale or pledge of the LLC's Senior Notes to the third-party lenders. Because the LLC is disregarded as an entity separate from Corporation A for gross income tax purposes, Corporation A's receipts from the sale or pledge of these Senior Notes will be treated for gross income tax purposes as the nontaxable receipt of borrowed money.

RULING

IC 6-2.1-1-2 provides that the term "gross income" does not include borrowed money. The Department rules, therefore, that Corporation A will have no gross income tax liability on the sale or pledge of the LLC's Senior Notes to third-party lenders. Because the LLC is disregarded as an entity separate from Corporation A for gross income tax purposes, Corporation A's receipts from the sale or pledge of these Senior Notes will be treated for gross income tax purposes as the nontaxable receipt of borrowed money.

8. Corporation A's transactions with the LLC and its receipts on behalf of or as servicer for the LLC, or on behalf of the Collateral Agent will be completely disregarded in determining Corporation A's adjusted gross income for adjusted gross income tax and supplemental net income tax purposes.

RULING

Pursuant to Treas. Reg. Section 301.7701-3(b)(1)(ii) a single member LLC is ignored as an entity separate from its owner. IC 6-3-1-3.5 and IC 6-3-1-11 provide that Indiana corporate adjusted gross income tax is based on Internal Revenue Code Section 63 "taxable income" with modifications. The calculation of supplemental net income tax is based on the adjusted gross income derived from sources within the State of Indiana pursuant to IC 6-3-8-2. The Department rules, therefore, that:

- (a) any income or receipts that Corporation A receives from transactions with the LLC will be completely disregarded in determining Corporation A's adjusted gross income and supplemental net income tax liabilities; and
- (b) any income received by Corporation A on behalf of the LLC will be includable in Corporation A's adjusted gross income for adjusted gross and supplemental net income tax purposes to the extent it is included in Corporation A's Internal Revenue Code Section 63 "taxable income," unless it is exempt or otherwise nontaxable pursuant to a specific provision found in IC 6-3. The Department, however, confirms that such income received by Corporation A on behalf of the LLC will be includable in Corporation A's adjusted gross income only once and not twice, *i.e.*, such income will not be included twice in Corporation A's adjusted gross income, once as received by Corporation A and once as received by the LLC.

The Department, also, rules that Corporation A's receipts on behalf of the Collateral Agent will be disregarded in determining Corporation A's adjusted gross income for adjusted gross income tax and supplemental net income tax purposes to the extent these receipts are not included in Internal Revenue Code Section 63 "taxable income."

9. For sales factor purposes, the LLC will be disregarded as an entity separate from Corporation A. Accordingly, Corporation A will not include in its Indiana sales factor:

- (a) amounts that it receives from the LLC from sales of Collateral Inventory;
- (b) amounts that it receives from the LLC for the processing of Collateral Inventory into products and for any other activities that Corporation A performs for or on behalf of the LLC;
- (c) amounts that it receives from the LLC as distributions;
- (d) amounts that it receives on behalf of or as servicer to the LLC; and
- (e) amounts that it receives on behalf of the Collateral Agent.

RULING

Pursuant to Treas. Reg. Section 301.7701(b)(1)(ii) a single member LLC is ignored as an entity from its owner. IC 6-3-1-3.5 and IC 6-3-1-11 provide that Indiana corporate adjusted gross income tax is based on Internal Revenue Code Section 63 "taxable income" with modifications. The Department rules, therefore, that for sales factor purposes, the LLC will be disregarded as an entity separate from Corporation A. Accordingly, Corporation A will not include in its Indiana sales factor:

- (a) amounts that it receives from the LLC from sales of Collateral Inventory;
- (b) amounts that it receives from the LLC for the processing of Collateral Inventory into products and for any other activities that Corporation A performs for or on behalf of the LLC; and
- (c) amounts that it receives from the LLC as distributions.

The Department, further, rules that amounts received by Corporation A on behalf of, or as a servicer for, the LLC from third parties are, in fact, received by Corporation A. These amounts, therefore, will be included in its Indiana sales factor, unless, a statutory provision can be found in IC 6-3 to eliminate these amounts from its sales factor. The Department, however, confirms that such amounts, to the extent they are includable in the sales factor, shall be included only once, and not twice, *i.e.*, such amounts will not be includable twice in Corporation A's sales factor, once as received by Corporation A and once as received by the LLC. Furthermore, such amounts will be included in Corporation A's sales factor numerator only to the extent these amounts are from "sales" of the LLC "in this state" as defined by IC 6-3-2-2(e) and (f).

The Department, also, rules that amounts received by Corporation A in an agency capacity on behalf of the Collateral Agent will not be included in its Indiana sales factor.

10. The receipts from the sale of the LLC's Senior Notes to third-party lenders will not be included in Corporation A's sales factors.

RULING

Pursuant to Treas. Reg. Section 301.7701-3(b)(1)(ii), Internal Revenue Code Section 63, IC 6-3-1-3.5 and IC 6-3-1-11, a single member LLC that is disregarded as an entity for federal income tax purposes is, also, disregarded for Indiana adjusted gross income tax purposes. IC 6-3-1-3.5 and IC 6-3-1-11 provide that Indiana corporate adjusted gross income tax is based on Internal Revenue Code Section 63 "taxable income" with modifications. The Department rules, therefore, that for adjusted gross and supplemental net income tax purposes, the Senior Notes will be treated as notes of Corporation A and the receipts from the sale of the LLC's Senior Notes to third-party lenders will not be included in Corporation A's sales factor.

11. In determining the applicability of Indiana's throw-back rule found at IC 6-3-2--2(e)(2)(B) to Corporation A, no receipts from the sale of product by the LLC will be included in Corporation A's Indiana sales factor numerator if the sale was into a state where either Corporation A or the LLC is taxable.

RULING

Pursuant to Treas. Reg. Section 301.7701(b)(1)(ii), Internal Revenue Code Section 63, IC 6-3-1-3.5 and IC 6-3-1-11, a single member LLC is ignored as an entity separate from its owner for federal income tax and Indiana adjusted gross income tax purposes. The Department rules, therefore, that in determining the applicability of Indiana's throw-back rule found at IC 6-3-2-2(e)(2)(B) to Corporation A, no receipts from the sale of products will be included in Corporation A's Indiana sales factor numerator if the sale was into a state where either Corporation A or the LLC is taxable.

Corporation A submitted the following statements addressing sales/use tax issues for Departmental review:

1. Corporation A will be entitled to an exemption from Indiana sales and use tax on all Inventory that it sells to the LLC at the commencement of this financing arrangement. Such sale will not make that Inventory taxable to Corporation A.

RULING

The Department recognizes that this inventory securitization is in substance only a financing arrangement and that Corporation A will continue to perform all of the same activities it currently performs as a manufacturer. For that reason, the Department concludes that the inventory securitization as a financing arrangement, should have no impact on the sales/use tax liabilities of Corporation A and that the sales of Inventory to the LLC should have no sales/use tax consequences.

Therefore, prior to the implementation of the financing arrangement (inventory securitization) Corporation A, as a manufacturer, is entitled to purchase tangible personal property exempt from sales/use tax under IC 6-2.5-5 et seq., including IC 6-2.5-5-5.1 and

IC 6-2.5-5-6. Subsequent to the implementation of the financing arrangement Corporation A remains eligible as a manufacturer for these same exemptions because the sale of Inventory to the LLC, which is made as an integral part of the implementation of a financing arrangement, does not make that Inventory taxable to Corporation A. The Department rules, therefore, that Corporation A will be entitled to exemption from sales/use tax on all Inventory purchases that it sells to the LLC at the implementation of the financing arrangement.

2. Corporation A will be entitled to an exemption from sales and use tax on all Inventory it purchases for sale to the LLC throughout this financing arrangement.

RULING

For the reasons set forth above, the sale to the LLC is not a transaction subject to sales/use tax. The Department rules, therefore, that Corporation A will be entitled to an exemption from sales/use tax on all Inventory it purchases for sale to the LLC throughout the financing arrangement.

3. The LLC will be entitled to purchase, use, store and/or consume all Collateral Inventory exempt from sales and use tax.

RULING

For the reasons set forth above, the purchase by the LLC of all Collateral Inventory from Corporation A under the financing arrangement is not a transaction subject to sales/use tax. The Department rules, therefore, that the LLC will be entitled to purchase, use, store and/or consume all Collateral Inventory under the financing arrangement from Corporation A exempt from sales/use tax.

4. Corporation A, as the processor of the Collateral Inventory owned by the LLC, will be entitled to purchase, use, store and/or consume manufacturing machinery, tools and equipment, capital equipment, consumables, utilities, environmental quality equipment and other tangible personal property, including Inventory, exempt from sales and use tax to the same extent it does now as a manufacturer.

RULING

For the reasons set forth above, Corporation A is a manufacturer both prior to the implementation of the financing arrangement and subsequent to the implementation of the financing arrangement. The Department rules, therefore, that Corporation A will be entitled to purchase, use, store and/or consume manufacturing machinery, tools and equipment, capital equipment, consumables, utilities, environmental quality equipment and other tangible personal property, including Inventory, exempt from sales/use tax to the same extent it does now as a manufacturer, including continuing to claim the utilities exclusion provided by IC 6-2.5-4-5.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in a statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

DEPARTMENT OF STATE REVENUE